MARKET COMMENTARY:
Tariffs, Trade, and Investment Implications

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Given the significant movements in equity markets, particularly in the United States and Canada, we believe it is timely to provide our perspective on current economic conditions,how they shape investment opportunities and the implications for Cidel portfolios. In this commentary, we will analyze both the short-term and long-term implications of the Trump administration's policies on trade, economic stability, and global investment trends. Our focus will be on identifying key opportunities while also outlining the risks that we will be mindful of in the months and years ahead.

Tariffs and Economic Uncertainty

Tariffs have become a dominant theme in financial markets and political discourse, generating both speculation and volatility. From our perspective, tariffs introduce a substantial degree of uncertainty. Historically, businesses have been hesitant to make significant capital investments in environments where the regulatory or trade landscape is unclear. This hesitation will likely suppress economic growth in the short term. The on-again-off again tariffs make it virtually impossible for many businesses to plan.

As investors, however, the more critical question is determining what will be the longer-term impact. The unpredictability of trade policy has led to a reassessment of supply chains, trade relationships, and corporate investment decisions. The lasting effects of these policies will likely redefine global trade patterns, impacting asset allocation strategies across multiple sectors. It is unlikely that many non-US business will have a sole source US supply agreement. They will have contingency plans should rules change or reduce their exposure to the US entirely. Monetary impact of tariffs is important in the short-term but the change in corporate behaviour will be long lasting.

Erosion of Trust

The most profound consequence of the trade policy is the possible erosion of trust in the United States' commitment to security and trade agreements. Since the end of World War II, the U.S. had been regarded as a reliable partner in international trade, diplomacy and will abide by agreements they have signed. However, the unpredictability in honouring agreements has introduced hesitation among global businesses and governments alike.

This lack of trust manifests in several ways:

1. **Diversification of Supply Chains:** Businesses are less likely to rely on U.S. suppliers for critical inputs, leading to increased diversification towards nations with more stable trade policies. This shift may reduce the dominance of U.S. firms in global supply chains.

2. **Data and Privacy Concerns:** Given the potential for trade policies to influence access to digital infrastructure, corporations and governments may seek to localize their data storage to jurisdictions with clearer regulatory commitments.

3. **China fills the vacuum left by the US:** China could gain power and these partnerships can be in areas such as humanitarian aid, infrastructure support or cancer research. China may fill the void – or some of it - and become a trusted partner to some nations possibly cementing its position as the preferred trading partner.

Potential Shifts in European Economic Policy

Another significant development is the potential shift in German fiscal policy away from its traditionally conservative stance. If Germany and broader Europe adopt a more expansionary fiscal policy, we could see a surge in infrastructure and defence spending, contributing to stronger-than-expected European economic growth.

The recent rally in European equity markets and the Euro currency suggest that investors are beginning to price in this possibility. If this shift materializes, it could present opportunities for investors seeking exposure to European markets at still-attractive valuation levels relative to the U.S.

Manufacturing and Labour Market Realities

One of the fundamental pillars of the USA economic policy has been the push to bring manufacturing jobs back to the U.S. However, the vision behind this policy appears to be rooted in an outdated understanding of manufacturing dynamics. Modern manufacturing relies less on manual labor and more on automation, robotics, and advanced computing. Even if factories are reshored, the job gains may be far smaller than expected, favouring highly skilled professionals over low-skilled labourers.

The broader implication is the need to focus on industries that benefit from technological advancements rather than those that rely on traditional manufacturing models. Companies at the forefront of automation, artificial intelligence, and high-tech manufacturing stand to gain from this structural shift.

Trade Deficits and Capital Flows

The issue of trade deficits is complex and cannot be fully addressed in a few paragraphs, but a critical consideration is how capital flows shift in response to U.S. trade policy. Consider a U.S. business purchasing machine tools from a German manufacturer: while dollars flow to Germany in exchange for goods, a portion of these funds have historically been reinvested into U.S. financial markets through purchases of Treasuries or other assets.

However, if the current environment leads to a reduction in global confidence in U.S. economic leadership, there could be a structural decline in the recycling of foreign capital into U.S. assets. This shift may have significant implications for Treasury yields, the U.S. dollar, and the ability of the U.S. to fund its deficit.

Important Investment Implications and Portfolio Considerations

1. **Europe's Strategic Realignment:** As Europe strengthens its economic and diplomatic ties with China, both regions may experience accelerated growth. Despite the recent outperformance of European markets relative to the S&P 500, valuation gaps between U.S. and European equities remain near historical highs, suggesting continued potential for European markets to deliver strong returns.

2. **Reassessing the Role of U.S. Treasuries:** Traditionally regarded as a risk-free investment, U.S. Treasuries now face headwinds from rising fiscal deficits (approaching 9% of GDP) and the potential reduction in foreign capital inflows. With the U.S. 10-year bond yielding 4.30% compared to 2.9% in Germany and 3.0% in Canada, many will begin assessing whether the additional yield premium justifies the potential risks associated with U.S. debt.

3. **Diversification Beyond U.S. Fixed Income:** While many U.S. companies remain attractive due to innovation in artificial intelligence and technology, we will consider broader diversification beyond U.S. Treasuries. Exposure to non-U.S. government bonds and corporate credit may provide both stability and enhanced risk-adjusted returns.

Conclusion

While the United States remains a critical player in global markets, recent policy shifts necessitate a recalibration of our investment strategies. Cidel believes there are many implications of the current trade uncertainty, shifts in global trust, and the potential for stronger European growth. The evolving landscape underscores the importance of our approach to diversification—not only in equities but also in fixed income allocations.

Going forward, the key challenge will be balancing exposure to U.S. assets while managing risks associated with trade disruptions, fiscal policy shifts, and changing global capital flows. As always, maintaining a well-diversified portfolio with a focus on long-term value creation remains paramount to our approach in navigating these uncertain times.

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